A Review of Kentucky's High-Tech Construction Pool and High-Tech Investment Pool

SEPTEMBER 2007 - PERFORMANCE AUDIT

The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

September 7, 2007

John Hindman, Secretary
Cabinet for Economic Development
Old Capital Annex
300 West Broadway
Frankfort, KY 40601

Re: Performance Audit of Kentucky's High-Tech Construction and Investment Pools

Dear Secretary Hindman:

We present our report on Kentucky's High-Tech Construction and Investment Pools. It is our hope that this review will highlight the New Economy and benefit the high-tech pools so that they will continue to operate effectively. We will be distributing the final version of this report in accordance with the mandates of Kentucky Revised Statute 43.090. Additionally, we also distribute copies to members of the General Assembly committees with oversight authority for Innovation, as well as other interested parties.

In accordance with Kentucky Revised Statute 43.090(1), the Cabinet must notify the Legislative Research Commission and the Auditor of the audit recommendations it has implemented and of the recommendations it has not implemented, and reasons therefore, within sixty (60) days of the completion of the final audit.

Our Division of Performance Audit evaluates the effectiveness and efficiency of government programs as well as completing risk assessments and benchmarking of state operations. We will be happy to discuss with you at any time this audit or the services offered by our office. If you have any questions, please call Ellen Hesen, Director of the Division of Performance Audit, or me.

We greatly appreciate the courtesies and cooperation extended to our staff during the audit.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

c: Robbie Rudolph, Secretary of the Governor's Executive Cabinet
Deborah Clayton, Commissioner, Department of Commercialization and Innovation

105 SEA HERO ROAD, SUITE 2
FRANKFORT, KY 40601-5404
TELEPHONE 502.573.0050
FACSIMILE 502.573.0067
WWW.AUDITOR.KY.GOV

Executive Summary

Audit Objective

The Auditor of Public Accounts has conducted a performance audit of the High-Tech Construction Pool and the High-Tech Investment Pool that are administered by the Department of Commercialization and Innovation (DCI) within the Cabinet for Economic Development. The audit's objective is to determine if the Commonwealth's investments through the high-tech pools are effective in achieving established goals and if the programs are being administered consistent with the intent of the law.

Background

The high-tech pools were established under the Kentucky Innovation Act during the 2000 legislative session as a means of funding the development and expansion of Kentucky-based businesses, researchers, and their suppliers. The Innovation Act was part of a first step by the state to develop what is known as the New Economy, which is economic development focused on innovative businesses in areas such as information technology or biomedical research. Businesses associated with the New Economy have a higher demand for a highly skilled and well-educated workforce.

The intended outcomes of the two high-tech funding pools were to create a greater density of high-tech and knowledge-based businesses in the Commonwealth, to create new jobs in those higher paid industries, and to stimulate the development of innovative products and ideas. From fiscal year 2001 through April 11, 2007, over $104 million has been approved for use in 97 different projects. Each of these projects was recommended by the Commissioner of DCI and then approved by the Kentucky Economic Development Finance Authority.

Methodology

In order to achieve the purpose of this performance audit, the laws, regulations, and policies related to the administration and management of the high-tech pools were reviewed and staff at the Cabinet for Economic Development were interviewed concerning their administrative practices. In addition, a sample of 25 projects funded through the high-tech pools was reviewed to determine if they were being sufficiently monitored and were meeting all agreed upon goals.

Conclusion

Overall, DCI staff are ensuring that the Commonwealth is making investments in high-tech pool projects as intended by law. However, there are areas where the agency needs to provide greater transparency and accountability in its actions by documenting administrative processes and reporting on the outcomes of funded projects. In addition, the Kentucky Innovation Commission, created under the Kentucky Innovation Act, has not met since sometime around 2003.

Executive Summary

Findings and Recommendations

1. There are no regulations, official internal policies, or other formal written guidelines to document the criteria and process used in administering the High-Tech Construction Pool and High-Tech Investment Pool. DCI should document the administrative process and requirements used for the high-tech pools in an administrative regulation to ensure transparency and consistency in government.

2. Annual reports produced by DCI are not sufficient to demonstrate the effectiveness and return on investment of projects funded through the High-Tech Investment Pool and the High-Tech Construction Pool. Current reports do not provide updated information on previously funded projects that would demonstrate the outcomes from the millions of dollars spent through the high-tech pools. DCI should increase the amount of information in their annual reports.

3. The Kentucky Economic Development Finance Authority does not produce statutorily required annual reports for completed projects funded through that agency. Annual reports should be produced as required to provide sufficient information and accountability on the outcomes of projects funded with state funds.

4. There is no documentation that DCI conducts regular on-site reviews to determine whether funding recipients are meeting the requirements of the funding agreements. A physical presence provides another step in the monitoring process that ensures state funds are being used for the required purpose. DCI should begin performing formalized and documented on-site visits to all funded projects.

While the following finding is not directed at DCI or the Cabinet, the Kentucky Innovation Commission could have an impact on the overall goals and administration of the high-tech pools and other New Economy programs.

5. The Commission has not met its statutory duties to provide guidance and oversight to the advancement of the knowledge-based economy in Kentucky. This Commission is required to meet quarterly, review the progress of Innovation Act programs, and provide on-going policy recommendations to develop Kentucky's knowledge-based economy. The Innovation Commission should be convened to comply with its statutory requirement. Additionally, the General Assembly should review the purpose, duties, and makeup of the Kentucky Innovation Commission to determine if revisions are needed.

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Chapter 1

Introduction and Background

Audit Scope

This audit reviews the management and oversight of the High-Tech Construction Pool and High-Tech Investment Pool by the Department of Commercialization and Innovation (DCI), an agency within the Cabinet for Economic Development. The objective of the audit is to determine if the Commonwealth's investments through the high-tech pools are effective in achieving established goals and if the programs are being administered consistent with the intent of the law and legislative intentions.

The two high-tech funding pools were created during the 2000 legislative session as part of a larger "New Economy" initiative to stimulate the growth of innovative and knowledge-based Kentucky businesses and research endeavors. In addition to discussing the need for administrative improvements, this report provides a general understanding of what the New Economy means to Kentucky and how it relates to the two high-tech pools reviewed in this audit.

What do the terms New Economy and Knowledge-Based Economy mean?

In order to understand the capabilities and effectiveness of programs created to support the New Economy, it is necessary to understand what the New Economy is and why funding programs that support its development is important to the economic health of the Commonwealth. *The 2007 State New Economy Index*, published by the Information Technology and Innovation Foundation along with the Ewing Marion Kauffman Foundation, defines the New Economy as follows:

> The term refers to a set of qualitative and quantitative changes that in the last 15 years have transformed the structure, functioning, and rules of the economy. The New Economy is a global, entrepreneurial, and knowledge-based economy in which the keys to success lie in the extent to which knowledge, technology, and innovation are embedded in products and services.

In this definition, the New Economy is used as a broad term for the transition from the traditional mass production corporate economy structure to one rooted in information technology, high-tech advancement, and innovation. The previous economic formula for success and prosperity was to attract capital for investment in large factories and infrastructure development. The New Economy emphasizes innovation through developing new products, services, and business models, and by transforming existing processes to make them more productive.

Chapter 1

Introduction and Background

The New Economy is driven by the ability to create and develop new ideas, products, and techniques. According to *The 2007 State New Economy Index*, there has been a tremendous rise in innovation and research investments due to the New Economy. As an example, business-funded research and development went from being 1.19% of the nation's Gross Domestic Product (GDP) in 1980 to 2.02% in 2002, nearly double. Further evidence of the drive to innovate and create new ideas in the New Economy is that the number of patents being issued in the U.S. has nearly doubled between 1984 and 2002.

Along with increases in research and development, businesses associated with the New Economy have a higher demand for a highly skilled and well-educated workforce. This has resulted in the use of the term "knowledge-based economy." In the definition of New Economy noted above, this term is used as a descriptor to demonstrate the need for an educated workforce in innovative and high-tech businesses; however, "knowledge-based economy" can also be used as a replacement term for New Economy. Both terms are routinely used interchangeably, so for the purposes of this report they shall also be considered to have a similar meaning.

Why is the New Economy/Knowledge-Based Economy important to the Commonwealth?

Per capita income is considered one of the most accurate indicators for overall state economic health. By supporting programs that increase per capita income, a state can help ensure better living standards for its population.

The Kauffman Foundation's *The 2007 State New Economy Index* found a positive correlation to the growth in per capita income with those states that demonstrated the highest scores within the New Economy indicators. According to this nationally recognized New Economy report, the correlation demonstrates that states that embrace the New Economy can expect to sustain greater per capita income growth.

The 2007 State New Economy Index compiles New Economy data for all states and compares and ranks them based on 26 different indicators. Examples of the 26 different indicators used for the ranking include such areas as workforce education, inventor patents, amount of technology in schools, and entrepreneurial activity.

According to *The 2007 State New Economy Index*, Kentucky ranked 45th overall for the development and implementation of New Economy sectors, however, the state did have higher rankings in some of the individual indicator categories. In comparison, Kentucky ranked 42nd overall in the previous version of *The New Economy Index* released in 2002.

While this is a drop in the overall rankings, the state did show improved rankings for 10 of 19 New Economy indicators that were used in both the 2002 and the 2007 version. Areas of improvement include such New Economy indicators as broadband telecommunications, number of patents filed, and IT professionals.

The authors of *The 2007 New Economy Index* state there are some problems with comparing the information between the current 2007 version of the report and the previous 2002 version due to changes in methodology such as increasing the number of indicators. Also, the authors used the most recently available federally published statistics at the time the 2007 report was published, meaning some indicator rankings are based on older data. As the most comprehensive report of its kind, this report series is still the best source for comparing the progress of all states in developing the New Economy.

In a separate report, the American Electronics Association (AeA) has published *Cyberstates 2007*. This group uses Bureau of Labor Statistics data from 2005 and 2006 to develop its own rankings of states and the high-tech industry. In this report, Kentucky ranks 28th in high-tech employment showing progress in creating jobs in this important sector of the economy, but the impact of that ranking is lessened due to the state ranking 42nd for average high-tech wages. It is these lower wages that continue to impact Kentucky's all-important per capita income indicator.

According to *Cyberstates 2007*, the average wage of U.S. high-tech workers was $75,501 during 2005, while the average U.S. worker made $40,499. Kentucky's average wage for all job classes was even lower, at $33,730. The *Cyberstates 2007* report also notes that high-tech employees accounted for 5.1% of the workforce in the U.S., but provided 10% of the total payroll. The overall result is that New Economy type businesses like those in the high-tech industry have the potential for greater impact on per capita income due to the higher wages being paid.

In addition to increasing wages, the creation and retention of actual jobs is also important. Through the economic activity spurred by New Economy programs, new businesses investing in newly developing or expanding industries are created which leads to the creation of more jobs. According to *The 2007 State New Economy Index*, from 1980 to 2001, all of the U.S. net job growth was from those firms that had been in business less than 5 years, while older firms actually lost jobs. In order for Kentucky to take advantage of the economic benefits of the transition to the New Economy, the state will have to support newer entrepreneurial firms.

Further benefits to be realized from Kentucky developing New Economy or knowledge-based businesses include a rise in educational quality and an increasing number of the state's residents with a higher education. Businesses focusing on areas such as computers, telecommunications, and

biomedical technologies have a need for workers that are well educated and experienced in related fields. In an effort to meet that demand, a state must invest in the quality of its educational system or lose New Economy businesses to more competitive states that can provide the needed personnel resources. As high-tech companies employ a greater percentage of the population, there is a greater part of the population with higher educational attainment. In this sense, economic development funding serves a dual purpose in increasing both the wealth of the state and the quality and level of the population's education.

Development of New Economy Initiatives in the Commonwealth

As part of Kentucky's first direct attempt to help develop the state's participation and advancement in New Economy sectors, the Kentucky Innovation Act was passed during the 2000 legislative session. It created an oversight Commission specific to the overall New Economy interests of the state, several new funding programs for businesses and researchers, and a new state agency to administer most of the new programs.

The oversight Commission, known as the Kentucky Innovation Commission, was created to act as an overall strategic umbrella organization to help monitor the success of the New Economy initiatives. The Innovation Commission is to provide reports on the progress of knowledge-based businesses, research and development initiatives, and related training and education. Based on any findings, the group was to offer policy recommendations to the Governor and General Assembly. Membership on the Commission includes the Governor, Senate President, and Speaker of the House, other state leaders, and eight at-large members appointed by the Governor. A complete membership list can be found in KRS 164.6015, included in Appendix II.

In addition, the Kentucky Innovation Act created a new agency within the Cabinet for Economic Development to act as the primary oversight and implementation agency for New Economy initiatives in the Commonwealth. Initially, this office was called the Office of the Commissioner for the New Economy, but it was later changed to the Department of Commercialization and Innovation (DCI). The primary duties of the office have remained the same, regardless of its name.

Funding programs initiated by the Kentucky Innovation Act are aimed at stimulating the development and growth of knowledge-based businesses along with greater research and development in both businesses and universities. Many of the programs are designed to stimulate start-up businesses in Kentucky. Other programs are meant to provide funding for product development and research at the state's universities, some requiring that researchers partner with a Kentucky business. These programs emphasize the connection often seen in the New Economy where cooperation between, and investment in, businesses and educational resources are essential.

With the importance of education in the Kentucky Innovation Act initiatives and the inclusion of funding for partnerships with universities, the Council for Postsecondary Education (CPE) was made an administrator for four of the Kentucky Innovation Act funding programs. CPE is required to contract with a science and technology organization for the actual administrative duties of these programs. Currently, the Kentucky Science and Technology Corporation is the contracted administrator. It is a nonprofit organization developed for the advancement of science, technology, and innovative economic development in Kentucky. DCI still retains its primary role as an oversight agency through final approval of the plans and contracts for these CPE programs.

Further information on the purpose and administrative structure of initiatives created through the Kentucky Innovation Act can be found in Appendix III. While other New Economy programs have been developed since the initial Kentucky Innovation Act, the focus of this report is the high-tech pools administered by DCI.

The High-Tech Construction Pool and the High-Tech Investment Pool

The High-Tech Construction Pool and High-Tech Investment Pool are both governed by KRS 154.12-278, the same statute that establishes DCI and gives that agency administrative authority over the pools. The following subsections of the statute provide the only definitions and administrative directions given to DCI for the two high-tech pools:

KRS 154.12-278 (3)(h) *Administer the high-tech construction pool and the high-tech investment pool.*

KRS 154.12-278 (4) *The high-tech construction pool shall be used for projects with a special emphasis on the creation of high-technology jobs and knowledge-based companies. The commissioner, in administering the high-tech construction pool, shall recommend distribution of funds and projects to the Kentucky Economic Development Finance Authority for its approval. The commissioner shall recommend any designated amount of pool funds to be set aside for any match requirements. Any funds used for matching purposes may include public and private funds.*

KRS 154.12-278 (5) *The high-tech investment pool shall be used to build and promote technology-driven industries and research-intensive industries, as well as their related suppliers, with the goal of creating clusters of innovation-driven industries in Kentucky. The commissioner, in administering the high-tech investment pool, shall be authorized to recommend funds to be used to support loans and grants, or to secure an equity or related position.*

KRS 154.12-278 (6) *The Kentucky Economic Development Finance Authority shall assure in their approval of funding of projects that the highest priority is given to knowledge-based companies in fulfillment of the purposes and intentions of the purposes of this section.*

Administration Process of the High-Tech Pools

There are no Kentucky Administrative Regulations or other formal written policies on the management of the two high-tech pools, so the general duties and processes were determined through interviews and a brief written summary provided by DCI staff. The following section summarizes the administrative processes implemented by DCI.

I. Application

The application process commences when a firm requests information or funding through either or both of the high-tech pools. Applicants typically discuss their business model and plans for the desired funding with DCI staff. Based on the results of the discussions, if staff feel that the firm meets the general criteria of the statute and will be successful with the proposed project, they will request more detailed information such as a business plan and further documentation on the uses of the funding. Once staff have reviewed and discussed the proposed project in detail, firms fill out the brief application form to formally request funding.

II. Recommendation

Once the applicant has provided all requested information to DCI, the details of the project proposal are compiled. This typically includes summaries of the project goals, funding amount requested, any matching funding obtained by the applicant, how the funds will need to be disbursed, and any requirements that must be met by the applicant during the funding process. If these details are acceptable to the Commissioner of DCI, then a recommendation for funding will be made to the Kentucky Economic Development Finance Authority (KEDFA) for final approval.

III. Approval

KRS 154.12-278 (4) and (5) both require that the Commissioner of DCI make the recommendation for funding through the high-tech pools, but it is KEDFA that makes the final decision. KEDFA is the main financial authority within the Cabinet for Economic Development and is responsible for funds that are disbursed for the purpose of economic development. KEDFA decisions to fund projects are made by the seven board members during monthly meetings. Applicants are normally called to these meetings to answer any questions KEDFA board members might have about the proposed project or the applicant. The meetings are also open to the public.

IV. Agreements

If the KEDFA Board approves the proposed project for funding through either of the high-tech pools, a detailed agreement is created to document how much funding the firm will receive and the stated purpose of the project. This agreement also includes the expectations and requirements of both DCI and KEDFA that may include the creation of jobs by the firm or other signs of economic progress.

V. Disbursement of Funds

All funds are disbursed by KEDFA according to the provisions of the agreement, which may include specific disbursal dates or reimbursement of expenditures. When a recipient seeks reimbursement from their approved funding, both DCI and KEDFA require proof of expenditures. All disbursements are made on the condition that the funding recipient is compliant with the terms of their agreement.

VI. Monitoring

All agreements contain provisions for reporting to DCI and KEDFA on the progress of projects. Staff review these reports to determine if funding recipients are meeting their obligations under the agreements. For those agreements that require a specific number of jobs to be created, DCI staff may confirm the new jobs using data collected through unemployment insurance filings to determine employment levels of the recipients. Other sources may also be used to determine if the information being reported by recipients is accurate.

Funding Levels of the High-Tech Pools

The High-Tech Construction and High-Tech Investment Pools were the highest funded programs to come out of the Kentucky Innovation Act, receiving $40 million in the first biennium alone. Initially, the high-tech pools were funded through KEDFA, but later funding has been appropriated by the legislature from other sources as well. Table 1.1 below has the combined funding sources and appropriations for both the High-Tech Construction Pool and High-Tech Investment Pool.

Table 1.1: Appropriations for the High-Tech Pools by Source of Funds

Funding Period	General Fund	KEDFA Funds	Bond Proceeds	LGEDF*	Totals
FY2001&FY2002	-	$40,000,000	-	-	**$ 40,000,000**
FY 2003	-	$10,000,000	-	$1,035,000	**$ 11,035,000**
FY 2004	$5,000,000	-	$15,000,000	$1,250,000	**$ 21,250,000**
FY 2005	-	$ 7,950,000	-	$3,625,000	**$ 11,575,000**
FY 2006	-	$ 7,485,000	$ 5,000,000**	$3,500,000	**$ 15,985,000**
FY 2007	$ 5,000,000	-	-	-	**$ 5,000,000**
Totals	**$10,000,000**	**$65,435,000**	**$20,000,000**	**$9,410,000**	**$104,845,000**

Source: Auditor of Public Accounts based on Kentucky Economic Development Finance Authority's FY 2006 Financial Statements and Independent Auditor's Report.

***** Local Government Economic Development Fund

****** Economic Development Bond

Table 1.1 shows nearly all of the appropriated funds have been approved for projects; however, not all of the funds have actually been spent due to the time it takes to implement the projects. Table 1.2 demonstrates the amount of funding that has actually been committed to various projects. Numbers provided are related to the time period that the project was originally approved for funding and not when the funds were actually spent.

Table 1.2: Project Commitments of High-Tech Pool Funds

Funding Period	Committed to Projects
FY2001&FY2002	$ 39,500,000
FY 2003	$ 10,437,000
FY2004	$ 22,157,500
FY 2005	$ 4,420,939
FY 2006	$ 17,736,693
FY 2007*	$ 9,780,000
Total	**$104,032,132**

Source: Auditor of Public Accounts based on data provided by the Kentucky Economic Development Finance Authority.

- As of April 11, 2007.

Funding for the high-tech pools does not lapse. It is carried forward into the next fiscal year when it is not committed to a project. In addition, not all projects expend the total amount of approved funding.

As of April 11, 2007, a total of $5,786,621 in funding has been returned to the high-tech pools for funding other projects. A further source of funding has come from loan payments of $4,820,841, providing additional funds to the pools. When combined with $812,868 in funds that have been carried forward and not yet committed to a project, the high-tech pools had $11,420,330 available for further funding projects as of April 2007. Table 1.3 demonstrates this.

Table 1.3: High-Tech Pool Fund Balance as of April 11, 2007

Appropriated Funds – FY2001-FY2007	$104,845,000
Committed Funds – FY2001-FY2007	$104,032,132
Uncommitted Funds	**$812,868**
Unused Funds Returned by Projects	$5,786,621
Loan Repayments from Funded Projects	$4,820, 841
Funding Returned to Pools	**$10,607,462**
Remaining Funds for High-Tech Pool Projects as of April 11, 2007	**$11,420,330**

Source: Auditor of Public Accounts based on data provided by the Kentucky Economic Development Finance Authority.

Chapter 2

Findings and Recommendation

Finding #1:

There are no regulations, official internal policies, or other formal written guidelines to document the criteria and process used in administering the High-Tech Pools.

Currently, the only source of documented administrative guidelines for the High-Tech Construction and High-Tech Investment Pools is KRS 154.12-278. This statute, however, only provides a brief definition and general purpose of each pool with few administrative instructions. The only significant administrative guidance provided by the statute is that the Commissioner of DCI recommends projects for funding through the pools and the Kentucky Economic Development Finance Authority (KEDFA) will have final approval over any of the proposed projects.

The descriptions given by the statutes for the two high-tech pools are:

KRS 154.12-278 (4): *The **high-tech construction pool** shall be used for projects with a special emphasis on the creation of high-technology jobs and knowledge-based companies.*

KRS 154.12-278 (5): *The **high-tech investment pool** shall be used to build and promote technology-driven industries and research-intensive industries, as well as their related suppliers, with the goal of creating clusters of innovation-driven industries in Kentucky.*

Other sources of written guidance are neither binding nor specific enough to provide a description of administrative practices. The *2002 Strategic Plan for the New Economy*, approved by the Kentucky Innovation Commission, identifies the preferred areas for state investments for the New Economy program. The Cabinet for Economic Development's Strategic Plan is more specific with regards to identifying goals for improving agency programs, but provides no detail on the daily management of over $104 million in grants and loans approved through the high-tech pools.

The Commissioner and Deputy Commissioner of DCI determine the criteria used in recommending projects for funding, how much funding will be recommended, and how the program will be monitored once funding is approved. DCI staff were able to provide a brief written summary of the general guidelines and criteria they use, but it is for internal use only and not an official document.

Verbal and informal guidelines do not provide the consistency, transparency, and archival histories provided by documented procedures. New staff members would require extensive on-the-job training without the benefit of documented guidelines. A loss of the experienced staff to provide training and transfer program knowledge would be an even more difficult obstacle without documented procedures.

According to Cabinet for Economic Development officials, administrative regulations or official internal policies have not been created because written guidelines would limit the flexibility of the funding provided through the high-tech pools. However, other New Economy development programs have more detailed statutes and do not appear to have been negatively impacted. The following are examples of these programs and the statutory references that contain the detailed guidelines:

- Kentucky Research and Development Program – KRS 164.6019 to 164.6025
- Kentucky Rural Innovation Program – KRS 164.6027 to 164.6033
- Kentucky Commercialization Fund – KRS 164.6035 to 164.6041
- Kentucky Innovation and Commercialization Center Program – KRS 154.12-305 to 154.12-315

These programs are administered by the Kentucky Science and Technology Corporation (KSTC). According to KSTC's annual reports, these programs have been successful even with additional written guidelines documented in statute by the General Assembly.

Recommendation 1:

The Department of Commercialization and Innovation should promulgate administrative regulations establishing guidelines for the management and administration of the High-Tech Construction Pool and the High-Tech Investment Pool. Allowances for flexibility in the allocation of the funds should be considered, but standardization for other processes should be implemented. The regulation should specify the information required during the application process, monitoring activities performed, documentation requirements of the fund recipients, and procedures related to a default or breach of contract.

Finding #2:
DCI's annual reports are not sufficient to demonstrate the effectiveness or return on investment of projects funded through the High-Tech Pools.

The annual reports produced by DCI only provide brief descriptions and total funding amounts for high-tech pool projects that were approved for funding during the preceding fiscal year. There is no detail on the effectiveness of the funded projects and the amount of funding that has actually been spent through the two high-tech pools is not noted. A reader is not able to determine if the projects funded through the high-tech pools are achieving agreed-upon goals, how projects are benefiting the state, or what has actually been paid towards the projects.

Although DCI does produce annual reports as required by statute and information on the two high-tech pool projects is included, the reports do not include the information required by statute, or envisioned by the 2002 Strategic Plan referenced in the statute. As part of the Kentucky Innovation Act, the High-Tech Construction and High-Tech Investment Pools should be included in the annual reports with sufficient information to demonstrate their effectiveness.

According to KRS 154.12-278(3)(b), DCI is the main oversight agency for monitoring the progress of initiatives created by the Kentucky Innovation Act. This oversight includes reporting on the progress of these initiatives with demonstration of their effectiveness. Specifically, the statute requires that DCI shall:

> Monitor the return on investments and effectiveness of the Kentucky Innovation Act initiatives as set forth in the Strategic Plan for the New Economy as approved by the Kentucky Innovation Commission, January 7, 2002, or as revised, and report annually prior to November 1 to the Kentucky Innovation Commission, the Governor, and the General Assembly.

The statute requires that the activities of the projects monitored during the previous year be reported, maturity of the funded projects is not a condition of reporting. The general progress being made by the funded projects that are active during the previous year should be included in any annual report produced by DCI. If there are few or no returns made on the projects then this should also be noted in an annual report.

The statute notes the 2002 Strategic Plan for the New Economy and authorizes it to serve as the guidelines for monitoring and reporting. The Strategic Plan is clear in its expectation of demonstrating how funding is being spent and what effect it is having. The Strategic Plan states:

> The state is investing a substantial amount of money in *Kentucky Innovation*, and just as private investors have the right to periodic information on how their funds are being used and what the prospects are for a positive return on their investment, so too should state policymakers have the information they need to track the performance of the New Economy initiative.

It is unclear why DCI does not include more information in its annual report given that funding recipients do provide DCI with information as to the project's effectiveness. The following examples demonstrate the type of information contained in project reports that are sent to DCI by the funding recipients and maintained in project files:

- The Kentucky Dataseam Initiative has placed over 3,000 computers in public schools since November 2006. The computers are being used by students to broaden and enhance their education. When the computers are not in use they are networked together to form a type of supercomputer. This networked supercomputer is used for cancer research by the Brown Cancer Center at the University of Louisville and has exceeded original expectations for returning results.

- Secat, Inc. is a research and development company dedicated to the needs of the aluminum industry in Kentucky and major users of aluminum, such as the automotive industry. With funding from the high-tech pools, Secat was able to expand its research capabilities and capacity. This has led to more modernization and innovation in manufacturing, an original goal of the Kentucky Innovation Act. It has also resulted in two high-paid research positions being created in less than a year and scholarships being given to University of Kentucky students.

The reports produced by the Kentucky Science and Technology Corporation are good examples of detailed annual reports using both numerical data and narrative discussion on the achievements and progress of this program. KSTC is the contracted administrator of numerous New Economy programs. The project discussions in the KSTC annual reports are a good model for DCI to adopt in developing a more extensive reporting process.

Recommendation 2:

DCI staff should produce annual reports that provide better information on the activities of the funded projects, as required by statute. Information pertaining to the High-Tech Construction Pool and High-Tech Investment Pool should include the progress of projects that have been funded, as well as whether the outcome is positive, negative, or unchanged. If a project has been completed, a summary of the final report should be included in the DCI annual report. The report should include both a narrative and quantitative representation of the projects funded in order to provide complete information.

Finding #3:
The Kentucky Economic Development Finance Authority (KEDFA) does not produce statutorily required annual reports.

According to KRS 154.20-150(2), KEDFA is to submit an annual overview report to the Legislative Research Commission (LRC) concerning the success or failure of each completed project that has been approved and funded. Currently, no annual reports on completed projects funded through KEDFA have been produced and sent to LRC in accordance with the statute. Instead, the staff at KEDFA send the minutes from the monthly KEDFA Board meetings to LRC. These minutes include discussions on projects approved for funding from any of the programs overseen by KEDFA. This does not meet the agency's obligation under the statute, which specifically states:

> On or before the first day of each fiscal year, the authority shall submit an overview report to the Legislative Research Commission, on the success or failure of each completed project, in order to determine the effectiveness of the Kentucky Economic Development Finance Authority.

As the principal financial oversight body for the Cabinet for Economic Development, KEDFA has the final approval over millions of dollars in funding projects, including the High-Tech Construction and High-Tech

Investment Pools. Due to the authority and oversight relationship that KEDFA has with the two high-tech pools, it would be expected that a discussion of the success or failure of any completed high-tech pool project would be included in an annual report produced by KEDFA.

While the monthly meeting minutes provide significant information on the projects funded through KEDFA, the law requires an annual report. Because funding projects, like those funded through the high-tech pools, require the funding recipients to file final project reports, KEDFA could easily produce a report on the successes and failures of completed projects.

KEDFA staff noted that, to their knowledge, an annual report has never been issued due to a long-standing agency interpretation. An internal memo was presented to document a November 1999 conclusion that the statute's reporting requirement only applied to the KEDFA direct loan program. KEDFA staff also considers that its authority to follow-up no longer exists once the funding period is closed and the agreement is completed.

The statute, however, does not make any program distinctions and clearly requires a summarized annual report that includes each completed project funded by KEDFA. This report is to be used by the General Assembly to determine the effectiveness of KEDFA. By not providing this tool, KEDFA is hampering a mechanism put in place by the General Assembly to ensure good governance of public funds.

Recommendation 3:

The Kentucky Economic Development Finance Authority should produce annual reports as required by KRS 154.20-150(2). These reports should include the successes and failures of each completed project that has been funded through KEDFA. As source information for the annual reports, KEDFA staff should use the final reports produced by funding recipients when a project is completed.

Finding #4:
There is no documentation that DCI conducts regular on-site reviews to determine whether funding recipients are meeting the requirements of the funding agreements.

There has been over $104 million committed to projects through the High-Tech Construction and High-Tech Investment Pools since FY 2001, yet there is no documentation of regular on-site reviews of the funded projects. With such a large amount of funding being expended, DCI staff should have a regular physical presence to ensure funds are being used in accordance with agreements and that projects are achieving all agreed-upon goals. The process for conducting on-site reviews should be included as part of any written internal policies used by DCI, and recipients should be notified of on-site reviews through their funding agreements. All official reviews should be documented in the project files.

A review of 25 sample agreements showed that none of the agreement files contained documentation that staff made official visits to project locations for the purpose of reviewing the accuracy of progress reports and determining project compliance with all requirements set forth in funding agreements.

Of interest, is that the small number of funding recipients contacted stated that DCI staff did conduct limited on-site visits for the purpose of reviewing funding usage and the progress being made towards achieving the required project goals. The responses from the recipients indicated that the DCI visits are irregular though; with one noting that DCI staff made visits on a regular basis, while others indicated visits were more rare.

Since there is no documentation of any of these visits or how a review was conducted, it is not possible to determine exactly what the visits entailed or how effective they may have been. Based on the interviews with the selected funding recipients, they felt on-site visits were an important part of the compliance review process. The responses of the funding recipients demonstrate the positive impact a physical presence can have in the oversight and review process. The funding recipient is much more aware of being monitored, which could prevent misuse or abuse of state funding.

Recommendation 4:

DCI should develop written guidelines for conducting and documenting regular on-site reviews of projects funded through the High-Tech Construction and High-Tech Investment Pools. These reviews should be conducted no less than annually, and the results should be documented in the DCI agreement files. By creating a process and criteria for conducting on-site reviews, DCI could better protect the state's investment.

Conclusions From Reviewing Selected High-Tech Pool Projects

There were 25 out of a total of 97 approved projects that were selected for review as part of this audit. The 25 selected projects were approved for funding during FY 2001 through FY 2007 with a total value of $27,315,000. The list of the 25 sample projects and their value are shown in Table 2.1.

Table 2.1: High Tech Pool Projects Selected for Review

Funding Recipient	Amount Approved	Date Approved
Intranasal Technology, Inc.	$2,000,000	2/22/01
Western Regional Center for Emerging Technologies-Murray State	$1,600,000	5/31/01
UK Research Foundation - Center for Pharmaceutical Science and Technology	$4,000,000	1/31/02
Proteomics Training Facility - UofL	$1,000,000	8/29/02
Workforce Dev Initiative - Murray State	$100,000	10/31/02
Kentucky Tech Service/KMAC	$350,000	10/31/02
Owensboro Biotechnology Alliance, Inc.	$300,000	5/29/03
UK Research Foundation/UofL Research Foundation - KY Cancer Experimental Therapy Program	$4,000,000	7/31/03
Belcan Partners, LLC	$800,000	10/30/03
UK Research Foundation - Natural Products Alliance	$250,000	10/30/03
CPE/KSTC - BIO Conference 2005	$100,000	1/27/05
Center for Information Technology Enterprise/ConnectKY	$1,900,000	4/28/05
Metacyte Business Lab, LLC	$750,000	7/28/05
UK Research Foundation - Center for Pharmaceutical Science and Technology	$1,240,000	8/25/05
Commerce Cabinet/ Office of Energy Policy - Clean Coal Processes	$2,000,000	8/25/05
The Jewish Hospital Foundation	$625,000	8/25/05
City of Paintsville - KY Highland Entrepreneur Center	$75,000	9/28/05
Madison Avenue Launch Team/Madison E Zone/Williamstown Innovation Center	$75,000	10/27/05
Cymbion, LLC	$650,000	10/27/05
Central Region ICC/Expert Management Organization	$250,000	10/27/05
Kentucky Dataseam Initiative, Inc.	$1,900,000	12/16/05
Alltech, Inc.	$1,000,000	2/23/06
Secat, Inc.	$850,000	3/30/06
Growth Services, LLC/Kentucky BioAlliance	$300,000	10/26/06
US Worldmeds, LLC	$1,300,000	12/7/06
Total	**$27,415,000**	

Source: Auditor of Public Accounts based on data provided by the Kentucky Economic Development Finance Authority and the individual project agreement files.

Additional information on the selected projects can be found in Appendix IV. Also, a full list of all 97 projects funded through the High-Tech Construction Pool and High-Tech Investment Pool can be found in Appendix V.

The purpose of the sample review was to determine the extent of monitoring activities conducted by staff, and if the projects have been successful in achieving the goals set forth in the funding agreements. Our conclusions that follow are based solely on the 25 projects reviewed.

Chapter 2

Findings and Recommendation

Documentation for the 25 sample projects shows both DCI and KEDFA staff review project activities.

Despite a lack of written guidelines, the amount of information in project files kept by both DCI and KEDFA shows that staff have engaged in a reasonably consistent review process. Staff are attentive to how funding is being used by recipients and ensuring that projects are meeting the requirements of the project funding agreements. This work is primarily accomplished through project reports, official letters, documented phone conversations, and email messages between staff and funding recipients. The funding recipient may also be required to attend KEDFA Board meetings during the funding approval process to answer any questions the Board may have about the proposed project. While not in the project files, Board meeting minutes are available and the meetings are open to the public.

Based on the email messages, letters, and other documents included in the projects' files, staff require proof for expenditures claimed by funding recipients. This includes invoices or summary expenditure reports produced by the funding recipients.

The reviewed projects were generally successful in meeting the requirements and goals established under the funding agreements.

All of the funding agreements for the 25 reviewed projects contained provisions for progress reports to be produced by the recipients. The intervals between the required submission dates of the reports varied between quarterly, semi-annually, and annually depending on the project. The information presented in the reports varies depending on the projects and the requirements of the funding agreements.

Based on the project agreements reviewed, requirements have mostly been met. There are exceptions of projects being at risk due to not meeting requirements, but these recipients requested a change in their agreements prior to any default. Usually, this involved an extension of the funding period and either extension or addition of goals. Since the overall desired outcome of the high-tech pools is to develop new and innovative businesses and research in Kentucky, this seems to be an appropriate step to ensure that recipients can meet their goals without jeopardizing state funding.

For those projects that have submitted progress reports, the required benchmarks and goals have been met or readjusted under new agreements. Most projects reviewed in the sample have benchmarks and goals that are spread out over several years. This means that for more recent projects it is not possible to make a definitive statement as to whether all projects have met those benchmarks and goals.

Findings and Recommendation

The requirements and conditions included in the funding agreements for high-tech pool projects have progressively changed since the inception of the programs.

Many of the earlier projects funded through the high-tech pools had general goals of starting programs or establishing infrastructure that would later serve the development of knowledge-based businesses. Progress reports typically included narratives on the accomplishments, but had no specific benchmarks to meet other than perhaps buildings being built or equipment being purchased. Several projects needed to just demonstrate "significant progress" at working towards a goal, although attainment of those goals was never required.

While two earlier projects required the creation of a certain number of jobs, it was not until the most recent two years that job creation has been included in an increasing number of funding agreements. According to DCI staff, the general policy is that the high-tech pools should fund projects that lead to the creation of high-tech jobs. Salaries of $50,000/year or more is typically required for each of the created jobs. A review of the 25 selected projects shows that this requirement is included in some of the funding agreements.

The requirements of the newer agreements reflect most recommendations from *The 2007 State New Economy Index*. That report suggests that incentives for New Economy programs should be contingent on higher wages for the jobs created, but stresses that the incentives should also be used to encourage innovation and not just job creation. Higher incomes provide greater impact on the per capita income and innovation increases another important economic indicator, productivity. As stated above, DCI requires higher wages for the high-tech pool funding and the funded projects are aimed at some type of innovation.

Finding #5:
The Kentucky Innovation Commission has not met its statutory duties to provide guidance and oversight to the advancement of the New Economy in Kentucky.

The Kentucky Innovation Act statutes created an oversight body, the Kentucky Innovation Commission, responsible for providing essential advice and direction on New Economy issues, but this Commission has not met in years despite the statutory requirement. According to KRS 164.6015(3) the Kentucky Innovation Commission "shall meet quarterly and at other times upon call by the chair."

The responsibilities of the Commission under KRS 164.6015 include:

- Providing "ongoing advice, direction, and policy recommendations to the Governor and the General Assembly relating to the status of Kentucky knowledge-driven businesses, research and development initiatives, and related high-skill training and education in the Commonwealth."
- Reporting annually on the progress the Commonwealth has made towards achieving a strong knowledge-based and innovative economy.
- Operate as a "strategic umbrella to advocate for the use of federal, state, local government, and private sector funds" that will create research and development projects and promote knowledge-based companies in Kentucky.

The statute designates support staff for the Kentucky Innovation Commission from the Office of the State Budget Director, but this agency has no record of any Commission activity for several years. According to staff at both the Cabinet for Economic Development and the Office of the State Budget Director, the Commission has not met since sometime around 2003. There are no available minutes of meetings or other related record of decisions, so it is not possible to tell when the last time a meeting took place or what type of work was completed prior to becoming defunct. Without these records, it cannot be determined why the Commission has not met and is no longer meeting its statutory duties and intent.

The Kentucky Innovation Commission was designed to help guide the state in the development of a stronger economy through the various programs and initiatives that were designed to stimulate research, innovation and modernization, and the creation of new knowledge-based Kentucky companies. The statutory members of the Commission represent the most powerful positions in the state, including the Governor, President of the Senate, and the Speaker of the House. Due to its membership, the Commission has the potential to impact and control the overall direction and coordination of Kentucky Innovation Act programs.

The Kentucky Innovation Commission is responsible for consolidating the information compiled and reported by agencies administering New Economy programs and to evaluate that information to determine the overall effectiveness of Kentucky's New Economy efforts. Kentucky's efforts to develop many of the sectors covered in these agency reports has seen an investment of at least $147 million in New Economy or knowledge-based economy programs since FY 2001. (See Appendix VI for a break down of these costs.) The oversight of these programs is dispersed through multiple agencies, which also scatters the reporting requirements.

Without the operation of the Kentucky Innovation Commission, there is no consolidation of agency program reports or evaluation of the overall effectiveness of New Economy programs. As stated in earlier findings, the annual reports related to the high-tech pools do not provide the type of information that could be used to determine effectiveness for specific knowledge-based programs. If the Commission were fulfilling its statutory duties, the information being published on New Economy programs would be reviewed and evaluated. Reporting inadequacies, like those found with the high-tech pools, would have to be corrected in order to satisfy the needs of the Commission.

In addition to the state leadership officials that make up part of the Commission, there are also eight "at-large" members to be appointed by the Governor. Criteria for these members include:

- Four (4) members of the private sector with management experience of high-tech or innovative businesses or enterprises.
- One (1) member engaged in the business of venture capital.
- One (1) member of the private sector engaged in providing or supporting communications infrastructure.
- Two (2) members who are recognized research engineers or scientists or educators with a background in teaching highly skilled workers or entrepreneurs.

This membership allows the Commission to have potential connections with the major sectors of the New Economy. Their experience and knowledge in developing businesses and educational projects would be invaluable in ensuring that the state is taking the correct steps to strengthen the new and developing industries that could enhance Kentucky's New Economy.

The High-Tech Construction and High-Tech Investment Pools have been operating with minimal long-term strategic and administrative guidance. Kentucky's Innovation Commission approved the *2002 Strategic Plan for the New Economy* but this plan has not been updated since its initial approval. Considering that this plan is one of the prime sources for determining industry sectors for investment and to provide long-term goals and recommendations, Kentucky's New Economy efforts are not being sufficiently controlled or supervised. By updating this plan, and providing continued policy recommendations and oversight, the Kentucky Innovation Commission could ensure that projects, including the high-tech pools, are meeting the long-term needs of the state.

In the absence of a formal strategic umbrella group, like the Commission, state officials must keep in contact on an informal basis to discuss New Economy issues as needed, but a loose communication network of state officials is not a complete solution. Such a generalized network has no established duties, meeting times, and their discussions are not open to the public. If active, the Kentucky Innovation Commission would provide the transparency and coordination needed to further advance Kentucky's development of the New Economy.

Recommendation 5: The Governor's Office, as the primary executive oversight authority, should convene the Kentucky Innovation Commission as required by statute. The eight at-large members should be appointed so that the necessary communication and oversight can begin as soon as possible. Additionally, the General Assembly should review the purpose, duties, and makeup of the Commission to determine if revisions are needed.

Scope and Methodology

Appendix I

Scope

The Auditor of Public Accounts conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The audits purpose is to address the following objective:

Are the Commonwealth's investments through the High-Tech Investment Pool and High-Tech Construction Pool effective in achieving established goals and are the programs being administered consistent with the intent of the law and legislative intentions?

In order to meet this primary objective we undertook steps to satisfy three sub-objectives:

- Determine if the Cabinet for Economic Development is meeting the monitoring and reporting requirements set forth in KRS 154.12-278, as it relates to the High-Tech Investment Pool and High-Tech Construction Pool.
- Determine if the Cabinet for Economic Development is administering the High-Tech Investment Pool and the High-Tech Construction Pool in accordance with KRS 154.12-278 and the principles of the New Economy in an efficient, effective, and appropriate manner.
- Determine if a sample of agreements funded through the High-Tech Investment Pool and High-Tech Construction Pool meet the requirements of the statutes and if the agreements have been managed and monitored in an effective and appropriate manner.

The scope of this audit was focused on the administration and oversight of the High-Tech Investment Pool and High-Tech Construction Pool by the Department of Commercialization and Innovation (DCI) and the Kentucky Economic Development Finance Authority (KEDFA), both administrative units within the Cabinet for Economic Development. The scope also included a review of the outcome and progress being made by selected individual projects that were funded through the high-tech pools. During the course of the audit, the scope also grew to include a review the Kentucky Innovation Commission due to the impact its oversight role could have on the projects selected for investments through the high-tech pools.

Scope and Methodology

Appendix I

Methodology

To form our criteria, we reviewed Kentucky's applicable statutes and regulations pertaining to the administration of the High-Tech Investment Pool and High-Tech Construction Pool. KRS 154.12-278 was identified as the only source of written guidance specifically for the two high-tech pools. There were no official regulations or agency policies related to the high-tech pools. Other statutes reviewed were indirectly related to the high-tech pools and pertained to KEDFA, who has final approval of high-tech pool projects, and the Kentucky Innovation Commission, a general oversight body for the state's New Economy programs.

Due to the lack of formal policies for the administration of the high-tech pools, we interviewed various staff from the Cabinet for Economic Development to determine general duties and guidelines implemented by agency personnel. The following offices within the Cabinet were interviewed:

- Acting Secretary of Cabinet for Economic Development
- General Counsel of Economic Development
- Department of Commercialization and Innovation
- Kentucky Economic Development Finance Authority

In addition, we interviewed staff of with the Legislative Research Commission and the Office of the State Budget Director to determine the previous and current activities of the Kentucky Innovation Commission.

We selected a sample of 25 projects, out of a total population of 97 projects, which had been funded through either the High-Tech Construction Pool or the High-Tech Investment Pool between FY 2001 and April 11, 2007. The basis for the judgmental sample was to ensure that a project from each of the fiscal years was selected, with greater weight being given to those projects approved during more recent years.

Files for each of the projects funded through the high-tech pools are kept by both DCI and KEDFA; therefore we reviewed the project files held by both agencies. In total, 50 files were reviewed. All documents within the reviewed files that were determined relevant to the administration of the high-tech pools were flagged. This information included:

- Original project agreements
- The most recent amended project agreements
- All attachments or exhibits describing the project and project goals
- Project reports produced by funding recipients
- Documentation provided by funding recipients demonstrating progress of the project
- Correspondence demonstrating administrative activities and decisions of staff

An attribute checklist was developed to record general information about each of the 25 sampled projects and to determine if each of those projects was meeting the goals established in the project agreements. Reports and supporting documentation produced by funding recipients provided the main source of determining progress in meeting required project outcomes. Correspondence from agency staff that was included as part of the project files was used to determine if there had been some form of verification of the funding recipients' reports. For four (4) of the sampled projects, telephone interviews with the project managers were conducted for further follow-up.

During the course of the audit we reviewed a variety of resources concerning the New Economy in Kentucky and abroad. These resources include:

- *The 2007 State New Economy Index*, produced by The Information Technology and Innovation Foundation and published separately by both the Ewing Marion Kauffman Foundation and the National Governor's Association.
- *Cyberstates 2007*, published by the American Electronics Association (AeA).
- *2002 Strategic Plan for the New Economy*, published by Kentucky's Office of the Commissioner for the New Economy (currently DCI).
- *Annual KSTC Report to Council on Postsecondary Education*, FY 2006, produced by the Kentucky Science and Technology Corporation.
- *FY 2006 Annual Report: Innovation and Commercialization Center Program*, produced by the Kentucky Science and Technology Corporation.
- 2005 and 2006 DCI Annual Reports
- *Cabinet for Economic Development 2006 Annual Report*, produced by the Kentucky Cabinet for Economic Development
- *Kentucky Strategic Plan for Economic Development 2005-2009: Fall 2006 Update*, produced by the Kentucky Cabinet for Economic Development

164.6015 Kentucky Innovation Commission -- Members -- Duties -- Support staff.

(1) There is established the Kentucky Innovation Commission, as an independent advisory commission, consisting of fifteen (15) members as follows:
- (a) The Governor or designee;
- (b) The secretary of the Governor's Executive Cabinet or designee;
- (c) The secretary of the Cabinet for Economic Development or designee;
- (d) The president of the Council on Postsecondary Education or designee;
- (e) The state budget director or designee;
- (f) The Speaker of the House or designee;
- (g) The President of the Senate or designee; and
- (h) Eight (8) at-large members appointed by the Governor as follows:
  1. Four (4) members of the private sector possessing extensive experience and expertise relating to managing a high-technology business or engaging in an innovation-driven, knowledge-based enterprise;
  2. One (1) member engaged in the business of venture capital;
  3. One (1) member of the private sector possessing extensive experience and expertise relating to providing or supporting communications infrastructure; and
  4. Two (2) members who are engineers or scientists recognized for their scientific or technological research efforts, or educators with an interest or background in teaching students to become highly skilled workers or entrepreneurs.

(2) The eight (8) at-large members shall serve terms of four (4) years, except that the original appointments shall be staggered so that two (2) appointments shall expire at two (2) years, three (3) appointments shall expire at three (3) years, and three (3) appointments shall expire at four (4) years from the dates of initial appointment.

(3) The commission shall meet quarterly and at other times upon call by the chair.

(4) Eight (8) members shall constitute a quorum for conducting business.

(5) Members shall receive no compensation except that the at-large members shall be reimbursed for actual and necessary travel expenses for attending meetings and performing other official functions, consistent with state reimbursement policy for state employees.

(6) A vacancy shall be filled in the same manner as the original appointment.

(7) The chair and vice chair of the commission shall be appointed by the Governor.

(8) The commission shall provide ongoing advice, direction, and policy recommendations to the Governor and the General Assembly relating to the status of Kentucky knowledge-driven businesses, research and development initiatives, and related high-skill training and education in the Commonwealth.

(9) The duties and responsibilities of the commission shall be to:
- (a) Promote the cooperation of private and public entities that have the purpose and duty of advancing the knowledge-based economy in the Commonwealth through technological innovation and knowledge transfer;
- (b) Report on the progress the Commonwealth has made annually toward achieving the goals in KRS 164.6013 through its agreed-upon benchmarks. In the setting of benchmarks the commission shall consider performance indicators recommended by public and private experts in and outside of the state in the fields of research and development and economic development, for the purpose of recommending benchmarks. Experts in this state shall include

but not be limited to representatives from the universities undertaking research and development activities, representatives of the Kentucky Science and Technology Corporation, representatives of targeted technology sectors, representatives of the Cabinet for Economic Development, and representatives of other state agencies having economic development and information technology responsibilities. Outside state experts shall include nationally recognized independent reviewers to assess the competitiveness of technology sectors in this state and the impact of research and development activities on economic development in the Commonwealth. Quantitative and qualitative indicators may include but are not limited to the following:

1. Kentucky companies modernizing to become more technologically innovative and globally competitive;
2. Research and development initiatives undertaken at Kentucky universities with federal, state, or private funds;
3. Educational attainment in areas that support the workforce needs of information technology and high-growth knowledge industries;
4. High-technology sectors and companies moving to and operating in the state;
5. Patents filed for technology or knowledge-based commercial products, processes, or services;
6. Businesses using electronic commerce and the communications infrastructure access capacity for Kentucky businesses;
7. Growth in corporate headquarters, research and development centers, high-income employees, and clustering of related technology industries and suppliers; and
8. Monitoring reports indicating progress made by the Kentucky Innovation Act investments as reported by the Department of Commercialization and Innovation and the Council on Postsecondary Education;

(c) Operate as a common strategic umbrella to advocate for the use of federal, state, local government, and private sector funds to create research and development projects, modernize manufacturing facilities, and promote knowledge-based, technology sectors and companies in the Commonwealth; and

(d) Report to the Governor and to the General Assembly annually on performance indicators, recommending benchmarks for measuring progress toward the advancement of the knowledge-based economy, technological innovation, and knowledge transfer, and reporting on the programs and initiatives set forth in KRS 164.6019 to 164.6041, 154.12-274, 154.12-278, and KRS 154.12-300 to 154.12-315.

(10) The support staff for the commission shall be from the office of the state budget director.

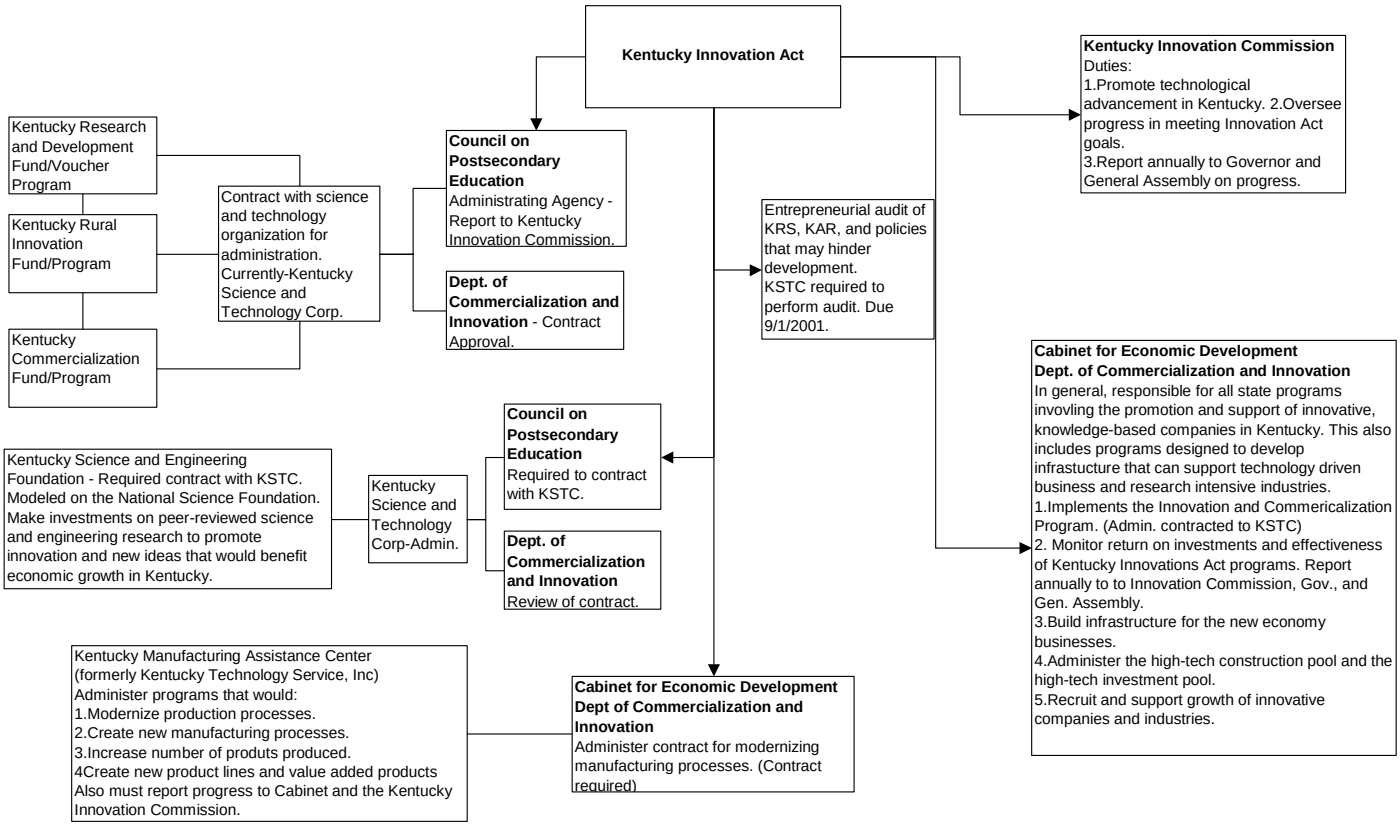
Effective: July 12, 2006

History: Amended 2006 Ky. Acts ch. 210, sec. 10, effective July 12, 2006. -- Amended 2005 Ky. Acts ch. 181, sec. 14, effective June 20, 2005. -- Amended 2002 Ky. Acts ch. 230, sec. 31, effective July 15, 2002. -- Created 2000 Ky. Acts ch. 522, sec. 3, effective July 14, 2000.

Kentucky Innovation Act Flow Chart

Appendix III

Source: Auditor of Public Accounts based on the Kentucky Innovation Act



Sample of High Tech Pool Projects

Appendix IV

Source: Auditor of Public Accounts based on sample review

					Actual Expenditure Amounts/Source		
Project #	**Recipient Name**	**Project Description**	**Approval Date**	**Total Amount Approved**	**Investment Pool**	**Construction Pool**	**Local Government***
2	Intranasal Technology Inc.	Construction and equipment costs for research and development of nasal delivery of pharmaceuticals	2/22/01	$2,000,000	$2,000,000	-	-
7	Western Regional Center for Emerging Technologies, Inc-Murray State University	Operating, construction, and equipment costs for technology business incubator and Innovation and Commercialization Center (ICC) facility	5/31/01	$1,600,000	$600,000	$1,000,000	-
16	UK Research Foundation, Inc	Equipment, start-up capital, and construction/expansion of the Center for Pharmaceutical Science and Technology	1/31/02	$4,000,000	-	$4,000,000	-
21	UofL Research Foundation, Inc	Equip and maintain a proteomics laboratory at UofL to act as a training facility for companies, students, and faculty. Proteomics is the study of proteins on a highly efficient scale.	8/29/02	$1,000,000	-	$1,000,000	-
28	Workforce Development Initiative - Murray State University	Funding for MSU's Telecommunications Systems Management, including 20 online courses targeted at KCTCS graduates to enhance training and education in telecommunication sectors.	10/31/02	$100,000	$89,345	-	-
29	Kentucky Technology Service, Inc/dba Kentucky Manufacturing Assistance Center	Operating costs for non-profit organization designed to help modernize Kentucky's manufacturers and make them more competitive	10/31/02	$350,000	$200,000	-	$150,000
38	Owensboro Biotechnology Alliance, Inc	Operating costs for plant-based pharmaceutical research and production using transgenic tobacco	5/29/03	$300,000	$300,000	-	-
42	UK Research Foundation, Inc/UofL Research Foundation, Inc	Provides funding for the establishment of the KY Cancer Experimental Therapeutics Program, meant to unite UK and UofL scientists and clinicians to develop and test new cancer treatments.	7/31/03	$4,000,000	$2,033,240	-	-
45	Belcan Partners, LLC	Anchor tenet at Morgan County-W.Liberty IT Center, recruit other high-tech firms to locate there, develop intern program with UK	10/30/03	$800,000	$800,000	-	-
46	UK Research Foundation, Inc	Establish an umbrella group known as Natural Products Alliance to stimulate entrepreneurial activity and start-up firms, leading to the commercialization of natural products.	10/30/03	$250,000	$229,454	-	-
52	CPE/KSTC	BIO Conference 2005 - Booth space/representation of Kentucky	1/27/05	$100,000	$62,466	-	-
59	Center for Information Technology Enterprise/ConnectKentucky	Expenses related to implementation of the Prescription for Innovation, resulting in high-speed internet acces to every Kentucky household by 2007	4/28/05	$1,900,000	$1,475,408	-	$424,592
60	Metacyte Business Lab, LLC	Operation costs for business incubator with a focus on life science and healthcare technology start-ups	7/28/05	$750,000	$750,000	-	-
61	UK Research Foundation, Inc	Center for Pharmaceutical Science and Technology operational funds for staffing expenses and FDA Regulatory Contingencies	8/25/05	$1,240,000	$993,811	-	-
68	KY Commerce Cabinet/Office of Energy Policy	Accelerate the deployment of clean coal processes through grants	8/25/05	$2,000,000	-	-	$948,252
69	The Jewish Hospital Foundation	Construction/expansion of the Cardiovascular Innovation Institute and funding for its executive director	8/25/05	$625,000	$125,000	$500,000	-
73	City of Paintsville	Operating expenses for Kentucky Highland Entrepreneur Center, providing leasable space, business and financial planning, and marketing assistance.	9/28/05	$75,000		-	$75,000
75	Madison Avenue Launch Team/Madison E Zone	Personnel and operating costs of Williamstown Area Innovation Center (ICC program)	10/27/05	$75,000	$75,000	-	-
76	Cymbion, LLC	Funding to help establish a bio-medical device manufacturing plant	10/27/05	$650,000	$623,830	-	-
77	Central Region ICC (CRICC)	Establish an Expert Management Organization (EMO) Pilot Program at the ICC to provide experienced management personnel for new companies with national/international market potential	10/27/05	$250,000	-	-	-
78	Kentucky Dataseam Initiative, Inc	Place at least 2000 computers in public schools and use them to develop networked computing grid for cancer research	12/16/05	$1,900,000	-	-	$1,853,352
82	Alltech, Inc.	Equipment purchase for expanded genomics and nutrigenomics R&D work at Jessamine County headquarters	2/23/06	$1,000,000	-	-	-
86	Secat, Inc	Research and development equipment for aluminum research	3/30/06	$850,000	-	$267,057	-
90	Growth Services, LLC/dba Kentucky BioAlliance	Fund the creation and operation expenses of a state-wide non-profit alliance for bioscience businesses	10/26/06	$300,000	$37,301	-	-
91	US Worldmeds, LLC	Operating expenses, including fees and costs related to FDA approval, for development and commercialization of a generic intravenous product and Lofexidine.	12/7/06	$1,300,000	$650,000	-	-
		***Local Government Economic Development Fund, appropriated for use under the high-tech pools**		**$27,415,000**			

Sample of High Tech Pool Projects

Appendix IV

Source: Auditor of Public Accounts based on sample review

Returned to Pool	Balance	Type of Funding	Funding Sources	Jobs required	Job types required	Average salary required	businesses to be created	Equipment to purchase	Building to be built	Reporting Method	not meeting requirements
$2,000,000	$0	Loan	Yes	40	-	-	-	Yes	Yes	audited financial statements	interest rate or $50,000/job
$0	$0	Grant	Yes	-	-	-	-	Yes	-	Quarterly Reports	Discretionary
$0	$0	Grant	Yes	jobs projected/not required	-	-	-	Yes	Yes	Annual Report and supporting docs	Discretionary
$0	$0	Grant	Yes	-	-	-	-	Yes	-	Quarterly reports and supporting docs	Discretionary
$10,655	$0	Grant	Yes	-	-	-	-	-	-	Quarterly reports and supporting docs	Discretionary
$0	$0	Grant	Yes	-	-	-	-	-	-	Quarterly reports and supporting docs/LGEDF report	Discretionary
$0	$0	Grant	Yes	-	-	-	-	-	-	Quarterly reports and supporting docs	Discretionary
$0	$1,966,760	Grant	Yes	-	-	-	-	Yes	-	Quarterly reports and supporting docs	Discretionary
$0	$0	Grant	No	15	professional	$50,000	-	-	-	Quarterly reports and supporting docs	Discretionary
$20,546	$0	Grant	No	-	-	-	-	-	-	Quarterly reports and supporting docs	Discretionary
$37,534	$0	Grant	Yes	-	-	-	-	-	-	Final report	Discretionary
$0	$0	Grant	Yes	-	-	-	-	-	-	semi-annual reports	Discretionary
$0	$0	Grant	Yes	-	-	-	3	-	-	semi-annual reports	Discretionary
$46,189	$200,000	Grant	Yes	jobs projected/not required	CPST/CPST clients	-	-	-	-	semi-annual reports	Discretionary
$0	$1,051,748	Grant	No	-	-	-	-	-	-	semi-annual reports	Discretionary
$0	$0	Grant	Yes	jobs projected/not required	-	-	-	-	Yes	semi-annual reports	Discretionary
$0	$0	Grant	Yes	jobs projected/not required	-	-	Projected	-	-	semi-annual reports/reports to KSTC	Discretionary
$0	$0	Grant	Yes		-	-	-	-	-	semi-annual reports/reports to KSTC	Discretionary
$0	$26,170	Grant	No	477	Bio-medical device manufacturing	$18,500-$60,000	-	Yes	-	Annual Report	$1326/job/year
$0	$250,000	Grant	Yes	-	-	-	Projected	-	-	semi-annual reports	Discretionary
$0	$46,648	Grant	Yes	jobs projected/not required	-	-	-	Yes	-	semi-annual reports	Discretionary
$0	$1,000,000	Grant	Yes	40	12 Researchers/ 23 lab techs	$90,000/$40,000	-	Yes	Yes	Annual Report	$25,000/job/year
$0	$582,943	Grant	Yes	Create 3/Maintain 14	Not Specified	$50,000	-	Yes	-	Annual Report	$170,000/job/y
$0	$262,699	Grant	Yes	-	-	-	-	-	-	Narrative Quarterly Report	Discretionary
$0	$650,000	Forgivable Loan	Yes	76/Maintain 3	75% R&D and management	$91,130	-	Yes	-	disbursement of funds (2) and annual financial statements	a formula for not meeting wages

All High Tech Pool Projects

Appendix V

Source: Kentucky Economic Development Finance Authority

	Project Name	Approval Date	Approved Funding
1	Downtown Lex. Tech. Center-The Factory	withdrew	$0
2	Intranasal Technology Inc. (L)	2/22/01	$2,000,000
3	Technology Innov. Ctr. at Louisville Med Center	3/28/01	$5,000,000
4	eMain-Louisville Development Authority	6/29/00	$2,500,000
5	Madison E-Zone Commercialization Center	5/31/01	$500,000
6	Eastern Kentucky ICC	6/28/01	$5,000,000
7	Regional Center for Emerging Technologies-Murray	5/31/01	$1,600,000
8	WKU Center for Research and Development	3/28/01	$4,000,000
9	WKU Integrated Eng. Applic. Lab	3/28/01	$1,000,000
10	Commonwealth Seed Capital LLC **	6/28/01	$11,100,000
11	Kentucky Innovation and Commercialization Centers	5/31/01	$1,300,000
12	West KY Energy/Environ Consortium	9/27/01	$400,000
13	SKEDC Information Tech. Center	9/27/01	$200,000
14	NKETCT (NKU Emerging Tech. Comm.Triangle)	9/27/01	$500,000
15	KY First (Madison Avenue Launch Team)	1/31/02	$500,000 (expired)
16	UK Research Found. (Ctr. for Pharm. Science)	1/31/02	$4,000,000
17	EKU - Regional Director/Safety & Security Director	6/27/02	$500,000
18	X-Ray Diffractor (Structural Biology) - U of L	8/29/02	$250,000
19	MetaCyte Business Lab - Louis. Med. Center Dev. Corp	8/29/02	$400,000
20	iTRC Ideas to Action Incubator - U of L	8/29/02	$300,000
21	Proteomics Training Facility - U of L	8/29/02	$1,000,000
22	Cardivascular Innovation Institute - U of L	8/29/02	$5,000,000
23	Madison E-Zone - Operations	8/29/02	$200,000
24	Visualization Center/21st Century Mfg. Initiative - UK	8/29/02	$5,000,000
25	Regional Center for Emerging Tech. - Murray State Univ.	9/26/02	$300,000
26	connectkentucky - CITE	9/26/02	$400,000
27	Institute for New Econ. Technologies (iNET) - NKU	9/26/02	$800,000
28	Workforce Dev Initiative - Murray State Univ.	10/31/02	$100,000
29	Kentucky Tech Service/KMAC	10/31/02	$350,000
30	eBusiness Strategy and Policy Group/CITE	10/31/02	$300,000
31	Cent. For Pharmaceutical Science - UK	10/31/02	$2,000,000
32	Public Safety and Security Institute - EKU	12/20/02	$1,300,000
33	Northern Ky New Econ Marketing Program/Tri-Ed	12/20/02	$500,000
34	The Factory - Lexington Fayette Urban Co Govt	withdrew	$0
35	Central Region Coordinator	1/30/03	$284,500
36	Barren River Develop Council-Rural Bus. Bldg Init.	1/30/03	$200,000
37	West Ky Energy Consortium Grant Project Pool	1/30/03	$2,000,000
38	Owensboro Biotechnology Alliance	5/29/03	$300,000
39	CITE/Rural Broadband Init. - Wayne Co.	5/29/03	$150,000
40	Paintsville/Johnson Co. Small Business Incubator	6/26/03	$500,000
41	Morgan Co. Regional Technology Center - UK	6/26/03	$435,000
42	Ky Cancer Experimental Therap Program - UK/Uof L	7/31/03	$4,000,000
43	Kentucky Natural Products Fund/Commonwealth Seed,LLC	9/25/03	$5,000,000
44	Madison E Zone/Invest by Being a Customer	10/30/03	$50,000
45	Belcan Partners/Morgan County-W.Liberty IT Center	10/30/03	$800,000
46	UK Research Foundation/Natural Products Alliance	10/30/03	$250,000
47	NKU/Rural Northern Ky Innovation Satellite/Grant Co.	10/30/03	$150,000
48	CITE/Sponsored Research Database	10/30/03	$50,000
49	UK Research Foundation/Aichi World Expo	4/29/04	$125,000
50	LMCDC/Metacyte Business Lab, LLC	12/2/04	$275,000
51	Sloan Center for Sustain Alum (SECAT)	1/27/05	$150,000
52	BIO Conference 2005	1/27/05	$100,000
53	Innov and Commercial Centers (KSTC)	1/27/05	$1,343,221
54	EKU - Eastern Region Satellites	1/27/05	$646,253
55	Murray State - Western Reg Satellites	1/27/05	$293,629

All High Tech Pool Projects

Appendix V

Source: Kentucky Economic Development Finance Authority

	Project Name	Approval Date	Approved Funding
56	Central Region Satellites	1/27/05	$271,944
57	Northern Ky - Williamstown Satellite	1/27/05	$40,893
58	MedVenture Technology Corporation	withdrew	$350,000
59	ConnectKY - Prescription for Innovation	4/28/05	$1,900,000
60	Metacyte Business Lab	7/28/05	$750,000
61	UK - Center for Pharmaceutical Science	8/25/05	$1,240,000
62	EKU Eastern Regional Director and East Satellites	8/25/05	$325,000
63	EKU - Safety and Security Director	8/25/05	$51,845
64	Central Region ICC and Satellite	8/25/05	$146,200
65	Madison E Zone	8/25/05	$60,000
66	Commerce/Dept of Energy - EnergyConsortium	8/25/05	$1,877,778
67	Commerce/Dept of Energy - Future Gen	8/25/05	$950,000
68	Commerce/Dept of Energy - Clean Coal Processes	8/25/05	$2,000,000
69	Cardiovascular Institute - Jewish Hospital	8/25/05	$625,000
70	UK Research Foundation/Pharmacy Closed Vial	9/28/05	$500,000
71	Murray State - RCET	9/28/05	$127,604
72	Murray State - Paducah IC	9/28/05	$64,182
73	Paintsville - Ky Highland Entrepreneur Center	9/28/05	$75,000
74	Kentucky Dataseam Initiative	9/28/05	$175,000
75	Madison E Zone/Williamstown Innovation Center	10/27/05	$75,000
76	Cymbion, LLC	10/27/05	$650,000
77	CRICC/Expert Management Organization (EMO)	10/27/05	$250,000
78	Kentucky Dataseam Initiative	12/16/05	$1,900,000
79	WKU Small Business Accelerator	1/26/06	$423,500
80	NKU Infrastructure Management Institute	1/26/06	$332,710
81	NKU Risk Management Institute	1/26/06	$276,973
82	Alltech, Inc.	2/23/06	$1,000,000
83	SKEDC National Bio & Agro Defense	2/23/06	$124,900
84	UK Research Foundation/Int'l Center for Engineering	withdrew	$1,436,000
85	ApoImmune	3/30/06	$500,000
86	Secat, Inc (Equipment)	3/30/06	$850,000
87	ConnectKentucky (CITE) 06/07	6/29/06	$950,000
88	Metacyte Business Lab 06/07	6/29/06	$750,000
89	Life Sciences Commercialization Program	9/28/06	$4,700,000
90	Growth Services, LLC/dba Kentucky BioAlliance	10/26/06	$300,000
91	US Worldmeds, LLC	12/7/06	$1,300,000
92	Semicon Associates, a division of Ceradyne, Inc.	12/7/06	$275,000
93	Aspen Compressor, LLC (EDB)	1/25/07	$500,000
94	Peptides International, Inc.	2/22/07	$175,000
95	SKEDC National Bio & Agro Defense	2/22/07	$80,000
96	TapLogic, LLC	3/29/07	$500,000
97	SearchDaddy, LLC	3/29/07	$350,000

State Investment in New Economy/Knowledge-Based Economy Programs Since FY 2001

Appendix VI

Program	Total State Investment	Administrative Agency
High-Tech Construction and High-Tech Investment Pools	$104,845,000	DCI
Innovation and Commercialization Center Program	$5,504,981	DCI (KSTC contracted administrator)
Kentucky Research and Development Voucher Program	$6,799,212	CPE (KSTC contracted administrator)
Kentucky Rural Innovation Program	$4,318,890	CPE (KSTC contracted administrator)
Kentucky Commercialization Program	$1,986,665	CPE (KSTC contracted administrator)
Kentucky Science and Engineering Foundation	$9,820,467	CPE (KSTC contracted administrator)
Kentucky EPSCoR	$14,128,725	CPE (KSTC contracted administrator)
Kentucky Manufacturing Assistance Center	$350,000	DCI
Total	**$147,753,940**	

Source: High-Tech Pool data provided by KEDFA; Data for ICC program provided by KSTC annual program report to DCI; Data for Kentucky Research and Development Voucher Program, Kentucky Rural Innovation Program, Kentucky Commercialization Program, Kentucky Science and Engineering Foundation, and Kentucky EPSCoR provided by KSTC annual program report to CPE; Kentucky Manufacturing Assistance Center contract not active and investment data not available.

CABINET FOR ECONOMIC DEVELOPMENT

Ernie Fletcher
Governor

Old Capitol Annex
300 West Broadway
Frankfort, Kentucky 40601
ThinkKentucky.com

John E. Hindman
Secretary

August 17, 2007

Crit Luallen
Auditor of Public Accounts
105 Sea Hero Road, Suite 2
Frankfort, Kentucky 40601-5404

Dear Ms. Luallen:

We are in receipt of your performance audit titled. A Review of Kentucky's High-Tech Construction Pool and High-Tech Investment Pool. While it is overall a positive audit, there were a few recommendations and we appreciate the opportunity to respond to each of those below.

Recommendation 1:
The Department of Commercialization and Innovation should promulgate administrative regulations establishing guidelines for the management and administration of the High-Tech Construction Pool and the High-Tech Investment Pool. Allowances for flexibility in the allocation of the funds should be considered, but standardization for other processes should be implemented. The regulation should specify the information required during the application process, monitoring activities performed, documentation requirements of the fund recipients, and procedures related to a default or breach of contract.

Agency Response:
The statutes authorizing the pools do not require promulgation of administrative regulations. The Department of Commercialization and Innovation does have written guidelines used by staff for review and approval of applications. Those guidelines are applied consistently; however, the nature of this program requires significant flexibility due to the uniqueness of each project and the early stage of the applicant companies so the guidelines do provide some room for exceptions. The Department of Commercialization and Innovation had already begun drafting new application forms and other relevant informational materials for use by applicants and will work on formalizing the existing internal policies. The concern expressed on page 9 of the audit document about new staff members is

not a realistic concern in light of the existing internal written guidelines which are available for use by new staff who may replace existing staff.

Recommendation 2:
DCI staff should produce annual reports that provide better information on the activities of the funded projects, as required by statute. Information pertaining to the High-Tech Construction Pool and High-Tech Investment Pool should include the progress of projects that have been funded, as well as whether the outcome is positive, negative, or unchanged. If a project has been completed, a summary of the final report should be included in the DCI annual report. The report should include both a narrative and quantitative representation of the projects funded in order to provide complete information.

Agency Response:
The Cabinet will implement some revision of the report to include more information on the project status. However, the narrative examples given in the audit include subjective self-reported information that may or may not add any true value to the report. Also, there will be many projects that have no information to report regarding return on investment because they are early-stage companies and are not expected to have a return in the formative years. Also, some projects were intended to create infrastructure and it will be impossible to determine a return quantitatively.

Recommendation 3:
The Kentucky Economic Development Finance Authority should produce annual reports as required by KRS 154.20-150(2). These reports should include the successes and failures of each completed project that has been funded through KEDFA. As source information for the annual reports, KEDFA staff should use the final reports produced by funding recipients when a project is completed.

Agency Response.
The statute cited in the audit as the basis for Recommendation 3 is not applicable to the pool programs being audited. When this statute was passed by the Kentucky General Assembly in 1988, it was part of a bill that included the original KRS 154 provisions and programs. (See Chapter 383 Kentucky Acts, Section 20 (1988).) The statute applied only to the programs in that Act. There are references to "...the proposed cost of a project **as defined by this Act**" [emphasis added] and to "...current status of each project, **as defined by this Act**". (1) (a-b) of Section 20. The other sections refer to the same "projects" which, based on the plain language would limit them to those same projects defined in the Act. The Act, at that time, provided only for cash programs like

loans, bonds, reclamation fund grants, and the reporting requirement was intended only to cover those programs created in that legislative Act.

When these provisions were all renumbered as part of KRS 154 in 1992, this provision was kept in the general KEDFA sections with the other provisions that were moved. Other programs thereafter provided for their own reporting requirements, separate and apart from this one. In fact, DCI has its own reporting requirement relative to the pools being audited, as noted in Recommendation 2. Based on the legislative history and intent behind this statute, the Cabinet always has taken the position that KRS 154.20-150 is applicable only to programs that were part of the original Act. (These pools were not.) The Cabinet provided to the audit staff a memo from 1999, where this same position is taken by the Cabinet with regard to another section of KRS 154.20-150 and another program, and the reasoning is the same. It is not a theory developed solely to address the audit. Furthermore, none of the recipients of the reports under this statute have ever suggested to the Cabinet that they believe the statute applies to all programs.

Additionally, the language of the statute doesn't really work with the pool programs because these early-stage projects are not "completed" by the end of the grant term. The grants are, for the most part, awarded to help companies get new high-tech products off the ground. The standard of "success and failure" is also subjective and hard to define for most projects, particularly these kinds of unique projects. Even if the statute did apply, it would be nearly impossible for KEDFA to comply with regard to the pool programs.

Recommendation 4:
DCI should develop written guidelines for conducting and documenting regular on-site reviews of projects funded through the High-Tech Construction and High-Tech Investment Pools. These reviews should be conducted no less than annually, and the results should be documented in the DCI agreement files. By creating a process and criteria for conducting on-site reviews, DCI could better protect the state's investment.

Agency Response.
As determined by the audit, DCI is already making site visits on projects. There are some projects that have no true facility to visit. Yet DCI staff members make visits at some point during the term of every project. The visits that have been made are apparently not sufficiently documented in the files and DCI will be documenting each visit as part of a more formal site visit process. However, if the phrase "no less than annually" is intended to mean an annual visit for every

DCI project, additional staff will be required which means additional funding will be necessary.

Recommendation 5:
The Governor's Office, as the primary executive oversight authority, should convene the Kentucky Innovation Commission as required by statute. The eight at-large members should be appointed so that the necessary communication and oversight can begin as soon as possible. Additionally, the General Assembly should review the purpose, duties, and makeup of the Commission to determine if revisions are needed.

Agency Response.
This program audit is titled "A Review of Kentucky's High-Tech Construction Pool and High-Tech Investment Pool". Finding No. 5 is related solely to the Kentucky Innovation Commission, a commission that has absolutely no statutory tie to these pools. While the Commission did have some oversight of the New Economy strategy being implemented at the time and these pools were named as part of that strategy, the audit report shows no statutory tie to these pools. Finding No. 5 is outside the scope of the audit. A review of this program should be limited to the scope of the program and the recommendations made should be recommendations the program being audited can implement. This audit falsely implies a connection between the Commission and the program being audited that does not exist.

The Commission was part of a particular strategy employed by a former administration. The current administration has used other successful strategies to promote the New Economy. The Office of New Economy was reorganized into the Department for Commercialization and Innovation. A new Commissioner was brought on board and a larger staff hired. The new Department implemented several innovative programs. Funding has been made available in significantly greater amounts for new economy programs and far more grants are being awarded to private companies for commercialization of true new economy high-tech products. The goals of the Innovation Commission are being met in a better and more direct way.

As a point of clarification, the audit states there are no available minutes of meetings or other related record of decisions. In fact, there are some minutes from Innovation Commission meetings that were maintained by the former Commissioner of the Office of New Economy within the Cabinet. The Cabinet was not asked to produce those minutes and would provide them upon request.

In closing, please note that we appreciate the professional conduct of your staff throughout the process and welcome this opportunity to address the recommendations made in this performance audit.

Sincerely,

John E. Hindman
Secretary

AUDITOR'S REPLY

Auditor's Comments to the Response to Finding/Recommendation 3

In its response to this finding/recommendation, the Cabinet correctly notes that the original reporting provisions under KRS Chapter 154, enacted during the 1988 General Session, were limited only to projects as defined by the original Act. During the 1992 General Session, however, the statutory provision limiting reporting to only those projects defined by the original Act was repealed. (See, Kentucky Acts, Chapter 105, Section 21 (1992).) The specific repeal of the statutory provision defining those projects needing to be reported had the effect of broadening the scope of projects on which KEDFA is to report. While the original intent of the statutes may have been more limited, KRS 150.20-150(2) is very clear on what is required now, and that is that KEDFA is to complete an overview report of all completed projects approved by KEDFA. The 1999 memorandum from a manager to a commissioner provided by the Cabinet attempts to interpret the intent of the law based on a statute that was no longer effective. Such a memo does not supersede or modify the requirements of the law as currently written.

While a long-term project funded through the high-tech pools may not be completed prior to or at the same time the grant or loan period ends, there still should be some reportable actions during the funding period. The Cabinet should make a good faith effort to report at the close of a grant or loan period on any successes or failures involving a project during the time period the project was funded.

Auditor's Comments to Response to Finding/Recommendation 5

The APA strongly disagrees with the Cabinet's assessment that a finding concerning the Kentucky Innovation Commission is outside the scope of this audit. The audit scope is determined by the Auditor of Public Accounts. The scope was focused on the management and administration of the High-Tech Construction Pool and the High-Tech Investment Pool. As stated in the report, the Kentucky Innovation Commission is not the direct responsibility of the Cabinet, but the Commission's relationship and potential impact on the high-tech pools cannot be ignored.

The Kentucky Innovation Commission was part of the greater Kentucky Innovation Act of 2000, as were the high-tech pools. The Kentucky Innovation Act was a comprehensive set of programs established to develop Kentucky's New Economy and included an integrated set of oversight controls with the Commission as the main source of that oversight. The high-ranking membership of the Commission, noted in the report, could effectively make changes to New Economy programs, like the high-tech pools, through policy recommendations. By not following the statutory requirements for the Kentucky Innovation Commission, the integrated and cooperative oversight that had been shared among top state leaders has been removed and oversight has become disjointed.

The Kentucky Innovation Commission was not just part of a strategy of a particular administration. As part of the Kentucky Innovation Act, the Commission was created to help ensure that Kentucky is being progressive in how jobs are created and how businesses are supported. The Kentucky Innovation Act was an entirely bipartisan piece of legislation, as can been seen in the nearly unanimous decision to pass the Act (38-0 in the Senate, 96-1 in the House).

Finally, the APA would like to clarify that this office did indeed request meeting minutes, or any other information that the Cabinet may have on the Kentucky Innovation Commission, at an initial meeting with Cabinet officials on February 23, 2007. At that time the Cabinet disavowed any relationship to the Commission and offered no documents related to that group.

Auditor of Public Accounts Information

Appendix IX

Contributors To This Report

Crit Luallen, Auditor of Public Accounts

Ellen Hesen, Director, Division of Performance Audit
Jettie Sparks, CPA, Performance Audit Manager
Jim Bondurant, Performance Auditor

Obtaining Audit Reports

Copies of this report or other previously issued reports can be obtained for a nominal fee by faxing the APA office at 502-564-0067. Alternatively, you may order by mail:

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105 Sea Hero Rd. Ste. 2
Frankfort, Kentucky 40601

visit : 8 AM to 5:00 PM weekdays

email: crit.luallen@auditor.ky.gov

browse our web site: http://www.auditor.ky.gov

Services Offered By Our Office

The staff of the APA office performs a host of services for governmental entities across the commonwealth. Our primary concern is the protection of taxpayer funds and furtherance of good government by elected officials and their staffs. Our services include:

Financial Audits: The Division of Financial Audit conducts financial statement and other financial-related engagements for both state and local government entities. Annually the division releases its opinion on the Commonwealth of Kentucky's financial statements and use of federal funds.

Examination and Information Technology: The Division supplies computer system control expertise and investigates citizen complaints. The Division audits computer system security and other controls and performs system data analysis. Our fraud hotline, 1-800-KY-ALERT (592-5378), and referrals from various agencies and citizens produce numerous cases of suspected fraud and misuse of public funds referred to prosecutorial offices when warranted.

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General Questions

General questions should be directed to Jeff Derouen, Director of Communication, at (502) 573-0050 or the address above.